Internal Revenue Service

memorandum

CC:TL:Br2
PLBurquest-Fultz

date: NOV 9 1987

to: Acting Assistant Commissioner (Examination) EX

from: Acting Director, Tax Litigation Division CC:TL

subject: Per Diem Payments in the Airline Industry Made in 1984

This memorandum is in response to your request for technical assistance on the tax treatment of per diem payments received by airline personnel while on flight duty.

In our memorandum dated October 8, 1987, we addressed the employment tax effects of per diem payments made in 1985 and later years. This memorandum addresses payments made in 1984, the only other year remaining open.

FACTS

Most commercial airline carriers pay an hourly per diem allowance to on-duty pilots and flight attendants. This allowance is in addition to in-flight meals, hotel accommodations, and some transportation costs paid directly by the airline on behalf of these employees. The per diem allowance is paid to cover incidental expenses as well as meals that are not provided in-flight, and is paid for each hour the employee is in flight-duty status. It is our understanding that flight-duty status covers the time during which the employees work one or more flights, including any rest at a stopover location. No accounting of amounts spent from the allowance is required by the airlines.

ISSUES

1. Whether the per diem amounts were subject to Federal income tax withholding under I.R.C. § 3402 in 1984.

2. Whether the per diem amounts were subject to FICA and FUTA under I.R.C. §§ 3121 and 3306, respectively, in 1984.

CONCLUSIONS

1. The per diem allowance paid by commercial airline carriers to their on-duty pilots and flight attendants was not subject to Federal income tax withholding for amounts paid in 1984.

2. The per diem allowance paid by commercial airline carriers to their on-duty pilots and flight attendants arguably was subject to FICA withholding for the employees' share of FICA contributions for payments made in 1984. The allowance arguably was also included in the applicable wage base for purposes of the employer's contribution for FICA and was subject to FUTA tax. However, a combination of litigation hazards and policy considerations cause us to recommend no FICA or FUTA assessments be made for 1984.

DISCUSSION

A. Introduction

In our memorandum of October 8, we concluded the per diem allowances were subject to Federal income tax withholding, FICA, and FUTA when paid in 1985 and later years. As stated in that memorandum, we believe that the per diem amounts are "fringe benefits" which are not excludable from income under section 132 for all years after 1984 and, accordingly, the amounts are subject to FICA, FUTA, and Federal income tax withholding. However, in the absence of direct reference to per diem allowances in the committee reports under section 132, we believe a court could hold excludability from wages is to be tested under regulations and rulings that preexisted the enactment of section 132.

Our analysis of this issue for 1984 is significantly different than our analysis for later years. The main difference is section 132 was yet to become law, so the applicable tests for exclusion in 1984 are the administrative tests established by regulations and rulings. We discussed those tests beginning on page 4 of our memorandum of October 8, and concluded the travel allowances in issue were not excludable from wages under any of those administrative tests. However, for 1984 several other factors come into play.

The most notable factors that affect our analysis for 1984 are the fringe benefit moratorium, the decision in Central Illinois Public Service Company v. United States, 435 U.S. 21 (1978), 1978-1 C.B. 310, and the Social Security Act Amendments of 1983. These factors are discussed below.

B. The Fringe Benefit Moratorium

The fringe benefit moratorium prohibited the issuance of regulations governing the income tax treatment of non-statutory fringe benefits. It was originally enacted effective October 1, 1977, as part of the Tax Treatment Extension Act of 1978, and was extended by subsequent statutes and by the Treasury Department itself through 1984. Pub. L. No. 95-427, 92 Stat. 996 (1978); Pub. L. No. 96-167, 93 Stat. 1257 (1979); Pub L. No. 97-34, 95 Stat. 172 (1981); and Treasury Department News Release R-2461. Although, the express prohibition was one against issuance of final regulations concerning fringe benefits, the Explanation accompanying the Report of the Committee on Ways and Means, H.R. Rep. 1232, 95th Cong., 2d Sess. 2508 (1978), provided,

> While the provisions of this bill relate only to the issuance of regulations, it is the intent of the committee that the Treasury Department will not alter, or deviate from, in any significant way the historical treatment of fringe benefits through the issuance of revenue rulings or revenue procedures, etc.

The Treasury Department applied the moratorium to rulings, stating that current administrative practice would not be changed during the moratorium period. See Treasury Department News Release R-2461 and Announcement 84-5.

The Service has interpreted the moratorium to apply unless there was a prior published position concerning the particular fringe benefit. Unless a fringe benefit was included in income or wages by a prior regulation, revenue ruling or similar published position, we have not taken a position that such a benefit was income or wages during the moratorium.1/

1/ The legislative history of Pub. L. No. 95-427 and Pub. L. No. 96-167 indicates fringe benefits include only noncash benefits furnished employees or allowances or reimbursements paid them with respect to certain personal expenses. See H.R. Rep. No. 95-1232 at 4-5; H.R. Rep. No. 96-433 at 3-4; and H.R. Rep. No. 96-448 at 2-3. The only payments considered fringe benefits in those committee

The moratorium evidences Congress's general concern that the Service not become too aggressive regarding new fringe benefit positions for years prior to 1985. Litigation hazards resulting from its enactment are discussed later in this memorandum.

C. Central Illinois Public Service Company

In Central Illinois Public Service Company v. United States, 435 U.S. 21 (1978), the Supreme Court held that a $1.40 noon lunch reimbursement paid employees on non-overnight travel in 1963 was not wages subject to

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Footnote 1/ continued

reports are compensation in some form other than money, whether the employer provides the benefit directly or pays the employee an allowance or reimbursement for his expenses in securing the benefit.

In the situation at hand, there is considerable basis for advancing an argument that the moratorium was inapplicable to these travel allowances. Indeed, they were not travel allowances at all but were an integral part of the bargained for hourly wage structure. They were paid every hour while an employee was on flight duty status, regardless of whether on a day trip or an overnight trip. They were paid regardless of actual expenses incurred and were in addition to the lodging, meals, and transportation furnished in kind. No accounting to the airlines was required and, except for the label affixed thereto, the allowances were indistinguishable from other hourly wages received.

The problem is that such an argument conflicts with our conclusion that the allowance is a fringe benefit to be tested under section 132 for 1985 and later years. And, we do not believe the section 132 tests do not apply to the travel allowances. The description in the legislative history of the Tax Reform Act of 1984 of fringe benefits as including "allowances for meals when the employee is not away from home overnight" makes no exception where the meal allowance is a bargained for hourly rate paid regardless of whether meal expenses were actually incurred and accounted for by the employee.

withholding. The money was only paid to employees who purchased or brought their lunches; no reimbursement was paid to employees who went home for lunch. The $1.40 rate sometimes exceeded and sometimes fell short of the costs incurred. An accounting of actual expenses was made to the employer. The $1.40 figure had been established through negotiations with the union representing employees.

The decision does not provide clear guidance for employers or the Service to apply to situations beyond its narrow factual scope. Largely, the opinion addresses the Court's conclusion that all income of an employee is not necessarily wages subject to withholding. The Court stated that the term wages is a narrow one, but failed to set forth tests or standards to apply in determining whether payments to employees are wages. Rather, the opinion notes the peculiar nature of the withholding requirement. Because the employer is secondarily liable for tax that should have been withheld from the employee, the Court felt the employer's obligation to withhold should be precise and not speculative. The Court noted that no regulations or rulings required withholding on travel expense reimbursements in 1963 and concluded it was unfair to require an employer to fill this gap on his own.

The opinion casts aside Rev. Rul. 69-592, 1969-2 C.B. 193. We would have interpreted this ruling, at least prospectively, to have filled the gap the Supreme Court perceived. The court, however, states the ruling was inadequate not only because issued after the year in suit, but also because it failed to mention wages.

The opinion notes that Congress may subject lunch reimbursements to withholding if it chooses. Moreover, at footnote 12, the Court pointed out that it was not deciding whether a new regulation that, for withholding purposes, would require lunch reimbursements to be treated as wages under existing statutes would or would not be valid. The strong implication is that something more than a revenue ruling would be needed to subject meal or other travel allowances to withholding. But, no regulation was issued in view of the moratorium.

In Rev. Proc. 80-53, 1980-2 C.B. 848, the Service announced its implementation of the Central Illinois decision. The Rev. Proc. states that existing law will be followed as to whether fringe benefits are income. However,

when income, those benefits will not be treated as wages for withholding purposes if:

> 1. The payments are not the type of benefit treated as wages under the statute, a regulation, a revenue ruling, a revenue procedure, or a court decision; and
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> 2. There is a reasonable basis for the belief that such benefits should not be considered as remuneration for services.2/

Rev. Proc. 80-53 makes it clear that fringe benefits includable in income but not treated as wages must be reported on a Form W-2. Further, whether fringe benefits are wages for FICA and FUTA purposes is stated to be unaffected by the Rev. Proc.

D. The Social Security Amendments of 1983

In 1981, the Supreme Court extended the reach of the Central Illinois decision by holding that the definition of wages for purposes of FICA and FUTA had the same meaning as was used for Federal income tax withholding purposes. Rowan Companies, Inc. v. United States, 452 U.S. 247 (1981). Rowan was legislatively overturned by the Social Security Amendments of 1983, however, which added the penultimate sentence to the flush language in sections 3121(a) and 3306(b). This language states that nothing in the income tax withholding regulations which provides for exclusion from the

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2/ At least one commentator has suggested, and we agree, that courts would look to section 530 of the Revenue Act of 1978 for guidance as to what constitutes a "reasonable basis." This section specifically addresses controversies as to whether individuals are employees or independent contractors. However section 530 does define "reasonable basis." The definition includes reliance on a long-standing recognized practice of a significant segment of the taxpayer's particular industry. Such a practice is present here, as a failure to withhold on the per diem allowances was common throughout the airline industry. See, Winston and Winston, "Employment Taxation -- Retroactivity and the Definition of Wages," 57 Taxes 525, 527 (1979).

definition of wages will be construed to require a similar exclusion for FICA and FUTA purposes. The legislative history accompanying the Social Security Amendments of 1983 provides that this change was made because "amounts exempt from income tax withholding should not be exempt from FICA unless Congress provides an explicit FICA exception." S. Rep. No. 98-23, 98th Cong., 1st Sess. 42 (1983), 1983-2 C.B. 326, 333.

CONCLUSIONS

Thus, for the 1984 year, travel allowances fell under the broad umbrella of the Central Illinois decision as to income tax withholding, but were subject to the Social Security Amendments of 1983 as regards FICA and FUTA. Regarding withholding, the Central Illinois decision created an exemption from wages for meal and travel allowances, while the moratorium prevented the Service from changing the regulations underpinning the Central Illinois decision.3/ Regarding FICA and FUTA, Congress indicated they should fall beyond the reach of the Central Illinois decision and be excludable only should Congress so provide.

It is for these reasons, we conclude that in 1984 the airlines were not subject to Federal income tax withholding, but arguably were subject to FICA and FUTA with respect to the travel allowances paid to pilots and flight attendants.

LITIGATION HAZARDS AND POLICY CONSIDERATIONS

Notwithstanding our conclusion that the per diem allowances paid in 1984 arguably were subject to FICA and FUTA tax, we believe that the following litigation hazards and policy considerations require us to refrain from making

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3/ Our conclusion that the travel allowance is not subject to withholding tax in 1984 appears inconsistent with our conclusion that the travel allowance is subject to withholding tax in 1985 and later years even if a court holds the allowance not to be a fringe benefit tested for exclusion from wages under section 132. The explanation is that we would be willing to argue Central Illinois does not dictate the excludability of the travel allowance from wages for withholding purposes as an alternative position for 1985 and later years, but not as our primary position for 1984.

deficiency assessments for 1984. The following paragraphs discuss these considerations.

A. The Breadth of the Central Illinois Decision

The litigation hazards result from the lack of a clear standard which can be drawn from Central Illinois for use in situations beyond its factual scope. Although the Central Illinois decision specifically addressed noontime meal allowances which were small in amount, it has been used by several courts and the Service as support for holding that other employer payments or allowances were not subject to withholding. Thus, it remains as a potential "green light" for courts to narrow the definition of wages for FICA, FUTA, and Federal income tax withholding purposes. Examples of the decision's broad application are discussed below.

In Rev. Rul. 84-127, the Service ruled that mileage reimbursement payments in excess of the IRS-prescribed rate were not wages subject to FICA, FUTA, or Federal income tax withholding. As authority for this position, the ruling cites the employment tax regulations and Central Illinois. Thus, the ruling broadened Central Illinois by applying it in the FICA and FUTA context to a non-meal reimbursement situation and it did so after the effective date of the Social Security Amendments of 1983.

In Oscar Mayer & Co., Inc. v. Commissioner, 623 F.2d 1223 (7th Cir. 1980), aff'g 79-2 USTC ¶ 9572 (W.D. Wis. 1979), the Seventh Circuit exempted from FICA and FUTA the costs of employee personal use of employer provided autos. As grounds for this exemption, the Court cited the government's concession that amounts were not wages for Federal income tax withholding purposes on the basis of Central Illinois. In this memorandum, we have concluded that the per diem allowances would not be subject to withholding. This may provide grounds for a court to conclude that such amounts are also not subject to FICA and FUTA even though the Social Security Amendments of 1983 indicate a congressional intention that the definition of wages for FICA and FUTA not be controlled by the definition for withholding purposes.4/

4/ In enacting the Social Security Amendments of 1983, Congress made it clear that only it should create exemptions from FICA (and FUTA) taxes. However, that intent is found in

The Sixth Circuit also exempted from FICA taxable cash tuition assistance paid to employees for use in defraying their children's undergraduate college expenses in Western Reserve Academy v. Commissioner, 801 F.2d 250 (6th Cir. 1986). The court affirmed the trial court's holding on this issue based on Central Illinois.

In addition to the broad application given to Central Illinois by the above examples, the case has been cited by other courts in requiring that withholding obligations be "precise and not speculative."5/ Although these cases deal only with Federal income tax withholding, their rationale could be equally applicable to FICA withholding.

B. The Uncertainty Created by the Fringe Benefit Moratorium

The fringe benefit moratorium also presents litigating hazards. During the moratorium, taxpayers could claim that FICA, FUTA, and withholding responsibilities were unclear for

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Footnote 4/ continued

the legislative history and is not clear from the statute itself. The statute merely prevents exclusions from wages in the income tax withholding regulations to be applied to FICA and FUTA. One danger is a court could apply the express terms of the statute, yet find an exemption from wages for FICA and FUTA purposes without reliance on the withholding regulations. See Land O'Lakes, Inc. v. U.S., 514 F.2d 134, 140 (8th Cir. 1975), wherein the court stated: "Where statutory language is unambiguous. . . , we have no occasion to consider Congress' intent except as it is expressed in the statute itself."

5/ See Hotel Conquistador, Inc. v. U.S., 597 F.2d 1348 (Ct. Cls. 1979), cert. den'd, 444 U.S. 1032 (1979), where the court rejected any "broad or sweeping definition of wages," thereby requiring that employers be sufficiently put on notice of withholding responsibilities because the employer is secondarily liable for the employee's withholding tax. This principle would appear to apply equally to the employer's secondary liability for the employee's share of FICA taxes. The Claims Court followed this rationale in McGraw-Hill, Inc. v. U.S., 623 F.2d 700 (Ct. Cls. 1979), in exempting incidental moving expense reimbursements from withholding.

employer-provided benefits and that Congress was unhappy with administrative pronouncements imposing such responsibilities in the absence of legislation on the issue.6/ The Service announced that it would not deviate from the historical treatment of "fringe benefits," and while that term was not defined, it may have been reasonable for employers to conclude that allowances or reimbursement arrangements were exempted from FICA, FUTA, and withholding by Central Illinois or later cases and rulings. The moratorium remained in effect until section 132 was enacted as part of the Tax Reform Act of 1984.

C. Policy Considerations Supporting No Assessment for 1984

In addition to the litigating hazards discussed above, there are policy considerations which support refraining from making assessments for FICA and FUTA for 1984. Those considerations are discussed below.

Significant staff resources would be required to complete the employment tax audits of numerous airlines. These efforts may not be justified where there are substantial litigation hazards involved in an issue of first impression with little or no continuing application.

6/ The committee reports under the House Resolution that originally called for the moratorium indicate that Congress was concerned that the Service was making changes in the taxation of fringe benefits without congressional input. The Senate Report states:

> While the committee recognizes that the Internal Revenue Service constantly is reexamining the treatment of fringe benefits in accordance with its obligations to enforce the tax law, the committee also recognizes that it is primarily the responsibility of the Congress to legislate uniform and equitable tax laws.

See S. Rep. No. 95-746, 95th Cong., 2d Sess. 4 (1978), omitted by the conference substitute when the House Resolution was passed by the House and Senate.

Fairness considerations also indicate that we should refrain from making FICA and FUTA assessments for 1984. Even though the Social Security Amendments of 1983 paved the way for the Service to illustrate that the definition of wages for FICA and FUTA was different than for withholding purposes, the Service did not issue any regulations or rulings clearly delineating the differences. To now assert that amounts are subject to FICA and FUTA, but not subject to withholding, may create an unfavorable impression of the fairness of our tax laws and how they are administered. The Service may be overreaching by asserting employment tax liability when employers may not have been put on notice by regulations or rulings that the Service would treat amounts differently for FICA and FUTA purposes than for income tax withholding purposes.

In this respect, we are mindful of the admonition of Justice Powell in his concurring opinion in Central Illinois:

> It seems particularly inappropriate for the Commissioner, absent express statutory authority, to impose retroactively a tax with respect to years prior to the date on which taxpayers are clearly put on notice of the liability. [F]undamental fairness should prompt the Commissioner to refrain from the retroactive assessment of a tax in the absence of such notice or of a clear congressional authorization.

Our knowledge of the airline industry's treatment of per diem amounts was gained by an informant's tip. We do not know what other industries follow the same practice. It is conceivable that similar travel industries, such as the railroad industry, the trucking industry, and the bussing industry follow the same practices. It would be impossible to complete timely employment tax audits of those industries to assure similar treatment of per diem allowances, thereby resulting in some inequities in enforcement of Service position.

Moreover, we can expect FICA and FUTA issues to arise under varying factual patterns and to be decided by several Circuit Courts of Appeal with, perhaps, varying results. Particularly as the issue is not one that continues under the same law in later years, we are hesitant to defend FICA and FUTA assessments for 1984. We are also concerned that assertion of the applicability of FICA and FUTA for 1984 (when the law is unclear) may taint in litigation the

applicability of those taxes for later years (when the law more clearly favors the Service).

Perhaps the most significant policy consideration is the correlation of Social Security tax (FICA) burdens and benefits. The statute of limitations for changes to employees' 1984 earning records for Social Security benefits will expire on April 15, 1988. After that date, the amount of wages reported by the airlines and recorded by the Secretary are conclusively presumed correct, and benefits will be calculated according to those records. If litigation on the FICA tax liability for 1984 resulted in increased wages and FICA tax, conforming amendments to the Secretary's records would be required by the Social Security Act, even after expiration of the statute of limitations. The successful litigation of the FICA tax issue could possibly result in more benefits being paid out than tax collected.

As for FUTA taxes, they are probably insignificant. Because the wages on which FUTA taxes are computed is limited to only $7,000 a year for each employee, we can expect the flight attendants and pilots to have exceeded that limit. See I.R.C. § 3306(b)(1). Little, if any, additional FUTA tax would be attributable to the per diem allowances.

RECOMMENDATION

When the litigating hazards of defending FICA and FUTA assessments for 1984 are considered together with these various policy considerations, we believe it best that the Service refrain from making such assessments. We recommend no employment tax assessments be made with respect to the per diem allowances for 1984.

We remain available to assist you as problems develop from the audit of specific airlines for 1985 and later years.

Patrick J. Dowling

PATRICK J. DOWLING